

# SURVIVING A DEBT CRISIS:

Five Lessons for Europe from Latin America

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**Latin America lost a decade.  
Europe need not.**



# INTRODUCTION

## History repeats itself.

This is the common refrain that we have all recited since grade school. Yet all too often current events seem to be interpreted in a vacuum. All too often we view the pressing issues of the day as unique, and all too often we end up re-inventing the wheel trying to address them.

To be sure, the European sovereign-debt crisis raises issues and circumstances particular to a common market and the 21st century. At its heart, however, Europe's dilemma is an all-too-familiar debt crisis, the likes of which are well known to citizens of emerging-market countries. This is not to dismiss the suffering of Europeans. Rather, it is to offer a ray of hope: Debt crises have happened before, and the world has learned a lesson or two about fixing them.

This paper draws lessons from the Latin American sovereign-debt crisis of the 1980s. These lessons are applicable to today's Europe. Certainly, the world has changed since 1980, and Latin America is not Europe. Yet we feel these overarching lessons can help Europe emerge from the doldrums of recession. That Europe has repeated ineffective Latin American policy approaches suggests the urgency of this study. That Latin America ultimately uncovered a blueprint for recovery suggests optimism.

Latin America lost a decade to its debt crisis. Europe need not.

For 36 years, the Bertelsmann Foundation and the Bertelsmann Stiftung have developed an expertise in European and trans-Atlantic issues. As the Foundation expands to cover Latin America, we feel this is a perfect opportunity to demonstrate the relevance of the region to Europe.

Such a cross-regional, cross-temporal investigation underscores our conviction that in a highly interconnected global economy, few developments are purely regional. And in a world where history so frequently repeats itself, no mistake need be repeated.

We hope that you enjoy.

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# EXECUTIVE SUMMARY

This paper outlines five lessons from the Latin American debt crises of 1982-1989 and 2001-2002 that are applicable to present-day Europe:

- Fiscal reform alone cannot resolve a debt crisis. Austerity must be an element of a larger strategy, and not the strategy itself.
- The Latin American experience underscores the importance of economic growth in a recovery. A country that can grow can pay its debts.
- Latin America's Brady Bond program suggests a model for a market-friendly default that can trim debt overhang without exiling a country from international capital markets or a common currency union.
- Argentina's messy default in 2001 is not a blueprint for peripheral eurozone countries although important, but selective, lessons can be drawn from that event.
- Potential political blowback stemming from reform fatigue threatens progress. In Latin America, backlash to the Washington Consensus eventually boiled into a "pink tide" characterized by rollbacks on certain crisis-era reforms. It would be an act of hubris to assume a backlash could not occur in Europe as well.

As part of the Bertelsmann Foundation's Global Economic Dynamics (GED) project, the text outlines overarching histories, tendencies and best practices in global economics.

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# A FAMILIAR CRISIS

The causes of the crisis are well known: A glut of investors sought higher returns over low, risk-free rates. Countries that for years demonstrated volatile macroeconomics were suddenly able to borrow excessively. Governments burned through loaned funds to support consumption and postponed painful reforms. The model appeared sustainable when growth seemed consistent and inevitable. But when the bottom fell out of the global economy, the weight of inefficient industries and bloated governments exposed soaring debt and deficits.

The world waited with bated breath as the media reported the potentially existential consequences of a financial meltdown. With access to capital restricted or prohibitively expensive, a number of countries staved off default by turning to the lender of last resort, which provided bailout packages contingent upon austerity packages. The goliath to the north, whose facilities owned much of the debt, initially supported the harsh fiscal reforms that ground debtor economies to a halt.

Yes, without a doubt, the story of the Latin American debt crisis is well known. And its striking resemblance to the European sovereign-debt crisis grows out of shared underlying factors.

Both crises began with periods of excessive lending to countries with unstable macroeconomic histories. In the 1960s and 1970s, the growing US trade deficit, Vietnam war spending and the first oil shock generated a

massive pool of “eurodollars.”<sup>1</sup> OPEC price hikes funneled billions of dollars east. Eventually, these funds would be recycled west in the form of loans to Latin America.

The European sovereign debt crisis also began with a rash of borrowing. Amid unusually low long-term interest rates and a boom in US securitization investment, peripheral Europe received a strong influx of capital between 2002 and 2008. Portuguese public debt, for example, increased from 48 percent of GDP to 72 percent during that span.<sup>2</sup>

In both cases, loan supply and demand fed off each other. In the 1980s, loans to Latin America appealed to banks, which used floating interest rates and high premiums to ensure profits for funds that were otherwise gathering dust. The process also appealed to Latin American sovereign borrowers who could not otherwise access capital without resorting to official sources and their nagging conditions. Oil importers and exporters took out loans — the former to finance pricier oil; the latter to expand production. Interest rates were high, but commodity prices (and, in some years, inflation) were higher.<sup>3</sup>

In 21st century Europe, countries such as Greece and Portugal jumped at the opportunity to borrow in their own currency, while lenders believed that the new monetary union implied security. Borrowing countries expected the good times to roll, as the capital inflow often ended up as extra public spending or tax cuts. Meanwhile, fiscal deficits, generally

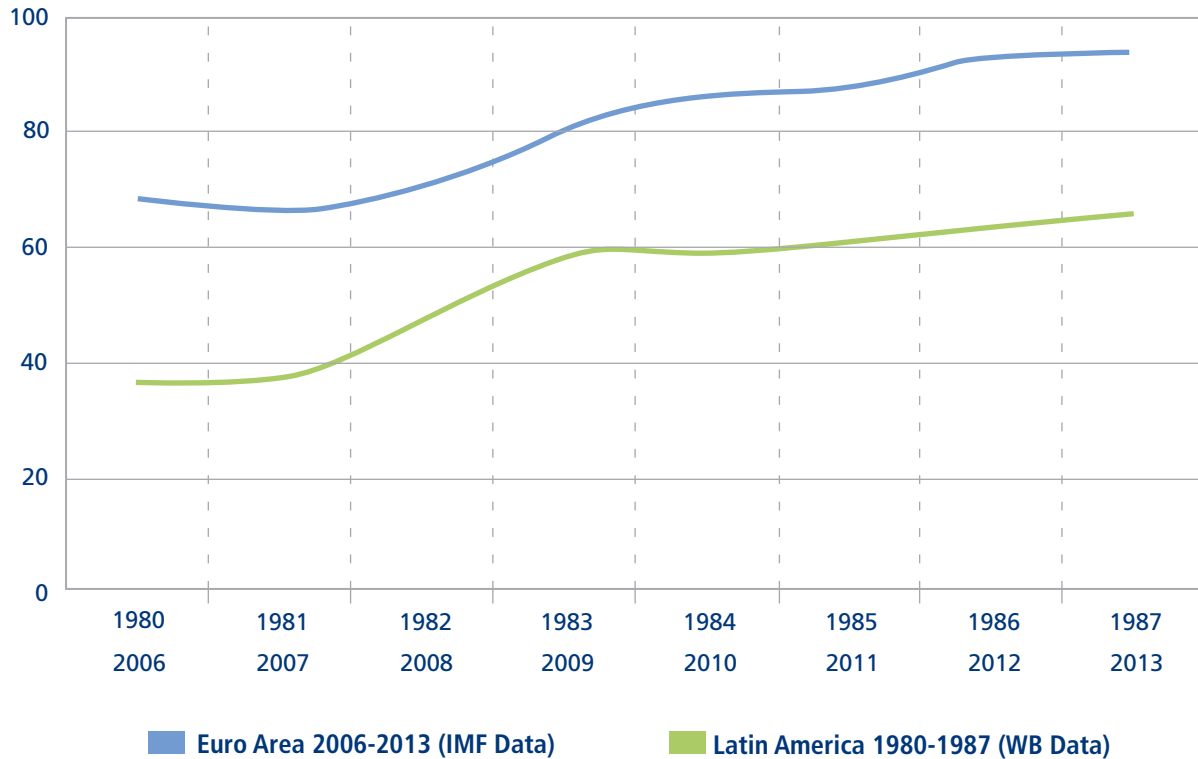
within the Maastricht Treaty band in the mid-1990s, expanded rapidly in the 2000s, with the Greek and Portuguese figures hitting double digits.

In both cases, a deteriorating global economy left the debt burden to sour into a crisis. When oil prices tripled with the second oil shock in 1979, Latin American import bills spiked while the US recession led to plummeting commodities prices. As the US tightened monetary policy, the floating interest on Latin American debt rose to nearly 20 percent by 1981.<sup>5</sup> When Mexico threatened sovereign default in August 1982, the reality of a full-fledged debt crisis crystallized. With lending effectively frozen throughout Latin America, much of the region was engulfed.

In Europe, the 2008 financial crisis derailed debt sustainability. Lack of short-term credit punished the European banking sector, leading to the Irish government’s fateful decision to guarantee in full private bank debt. Spain, which funneled a good deal of its borrowed money into construction, suffered the burst of the real-estate bubble. Greece and Portugal weighed down their books with debt during the 2003-2007 boom and could not finance deficits when lending froze and premiums increased.

This précis is neither controversial nor original, but rather a summary of conventional wisdom. Far more difficult than getting into a debt crisis is getting out of one. Since European Central Bank (ECB) President Mario Draghi’s

## Government Debt – Percentage of GDP



announcement of unlimited sovereign bond purchases from crisis-plagued members states in September of 2012, spreads have eased in countries such as Spain and Italy. This, however, does not mean the Euro crisis is over – only that it has moved from an acute to a chronic phase. How can a country shed debt while mired in recession? How can a country grow when it cannot pay interest? Can a structured default ease the debt burden without excommunicating a country from international finance? Latin America faced these questions in the 1980s and Europe faces them today.

### A Caveat

In the 1980s, Chile developed its vineyards to stimulate non-traditional exports. “Start producing wine,” however, would hardly be a lesson of value to European countries that have been exporting the drink since the days of the Phocaea in France (600 BC).

Latin America is not Europe. Chronically underdeveloped, Latin America emerged from its debt crisis with the capacity for rapid growth. Europe lacks any such slack. A common market represents challenges and opportunities for Europe that were not part of the Latin American

experience. In all of the subsequent five lessons, the fundamental differences between the Latin American and the European situations are easily noted.

But spotting the differences is easy. The challenge lies in identifying overarching trends that can point the way to transferrable solutions. Each of the following five lessons includes useful experience for Europe.

# LESSON 1: AUSTERITY ALONE CANNOT SOLVE A DEBT CRISIS

## Austerity in the time of recession - How to lose a decade

Since the true scope of the European sovereign debt crisis emerged in 2010, the crisis response has focused heavily on fiscal reforms. Whether through the six-pack of reforms or the speeches of French President François Hollande, growth-oriented reform has been part of the debate, but it has not resonated in concrete policy actions as it has with austerity reforms. Latin America attempted a similar response in 1980. It cost the continent a decade of growth and development, and it did not solve the debt crisis. Persistent yet ineffective emphasis on austerity led to years of lackluster growth in Latin America, now collectively referred to as “The Lost Decade”.

## Latin America and Austerity

As bank lending to Latin America ground to a halt in the fall of 1982, a consensus emerged among debtor governments, lending banks and the international financial institutions: The region’s problem was not one of solvency, but of liquidity. Prevailing theory held that countries such as Mexico, with 72 billion barrels of petroleum and natural gas in reserve, had the assets to meet debts – just not the cash at hand.

From 1982 to 1988, Latin American governments attempted to generate massive fiscal surpluses through internally and externally oriented austerity measures. Internally, these measures leaned on budget cuts, tax increases and the privatization of bloated

state-owned enterprises. Externally, austerity demanded a current-account surplus that, in the short term, could be generated only by import suppression. Through tariffs, quotas and licenses, Latin American imports dropped from US\$100 billion in 1981 to US\$40 billion in 1983.<sup>6</sup>

Meanwhile, rather than supporting a debt restructuring program that would represent a loss for commercial banks, the IMF lent *more* money to Latin America to cover immediate interest payments, with these funds contingent upon adopting “adjustment” policies that would promote fiscal consolidation.

With the emphasis on belt-tightening and little attention paid to growth, the results were disastrous. Per capita GDP shrank 0.9 percent across the region in the 1980s, while the percentage of those living in poverty increased from 35 in 1980 to 41 in 1990.<sup>7</sup> Moreover, debt-to-GDP ratios actually *increased* during the years of austerity, as government revenue failed to keep pace with the growing debt burden. Mired in recession, Latin American countries struggled just to make interest payments, despite posting current-account surpluses.

## Shock and Flaw

The austerity measures certainly shocked Latin American economies. In Chile, where reforms included value-added-tax increases and reduced public employment, per capita GDP dropped 9.1 percent from 1981 to 1985. In Peru, where the 1990 value of public social spending was but 21 percent of the 1980

value, an already poor population faced vicious GDP swings that included years of 11.8, 8.7 and 11.7 percent contraction. In Mexico, real wages fell 30 percent just between 1982 and 1984.<sup>9</sup> Of interest to modern-day Europe, region-wide austerity caused trade within Latin America to nearly halve, falling from US\$100 billion in 1981 to US\$56 billion in 1983.

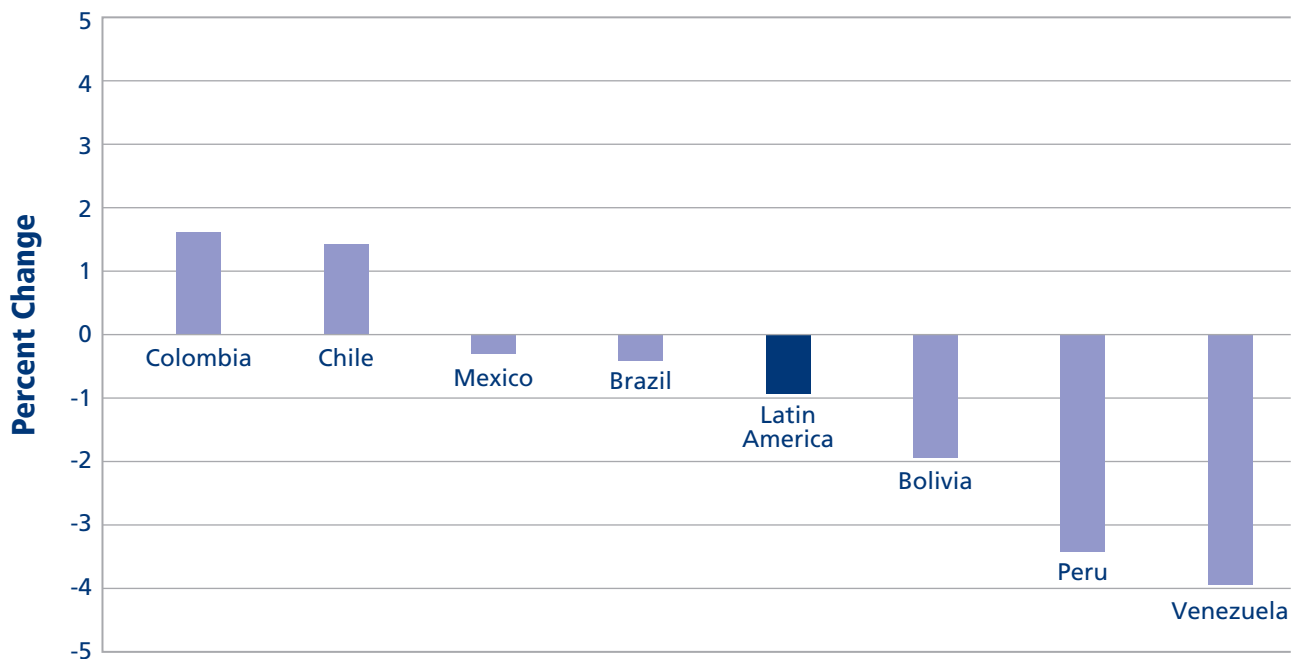
But the austerity measures did not end the debt crisis. Import suppression never created the windfall revenue required to meet debt payments. For one, most exporters were private, whereas most debt was public. Secondly, the stiff decline in consumption limited taxable transactions, while the decrease in imports limited tariff revenues, even as the tariffs themselves increased.

As noted, debt-to-GDP ratios increased throughout the region. In Mexico, a country that pursued fiscal cuts with particular zeal, public expenditures actually jumped from 21 percent of GDP in 1981 to 31 percent in 1987. This rise reflected the heavy burden of interest payments, which accounted for 50 percent of central-government expenditures in 1987.<sup>10</sup>

IMF financing helped countries cover these payments, but total outstanding debt ballooned. The aim of this so called “involuntary lending” was to tide over inherently solvent countries until they could re-establish the liquidity needed to pay off debts. However, given region-wide contraction in consumption, interest financing simply prolonged



## Per Capita GDP Growth, 1981 – 1990 Constant Prices



Source: ECLAC Statistical Yearbook, 2000

the crisis without diminishing the debt burden.

Eventually, creditors realized that hope of any resolution rested upon a return to growth and a trimming of the debt overhang. It just took them five years to figure it out.

### Europe's Lost Decade?

Just as in Latin America, the initial response to the European sovereign debt crisis focused intensely on austerity. The Washington parlor joke holds that IMF stands for "It's Mostly Fiscal." If anything, IMF fervor for fiscal reform was outdone by that of the EU. As peripheral risk premiums rose hundreds of basis points against German bonds, Greece, Ireland, Portugal and Cyprus all turned to official funding. Spanish banks also tapped the eurozone's bailout funds in late 2012.

Just as in Latin America, bailout packages came with a stiff price. Greece promised to reduce its fiscal deficit

from 13.6 percent of GDP to 2.6 percent by 2014, with similar pledges coming from Ireland, Portugal and Spain.<sup>11</sup> Italy, having avoided the primary deficits of its neighbors, promised to put a dent in its debt-to-GDP ratio, which topped 120 percent.

Just as in Latin America, the inability to generate rapid surpluses on the production side forced the recalibration to focus on consumption cuts. These austerity measures featured public-sector wage cuts, increased tax revenue, pension freezes, social-welfare trimming, reduced minimum wages and weakened labor protection, among others.<sup>12</sup> Italy went as far as to force the resignation of raffish Prime Minister Silvio Berlusconi (1994 -1995; 2001 -2006; 2008 -2011) to underscore that the party was over.

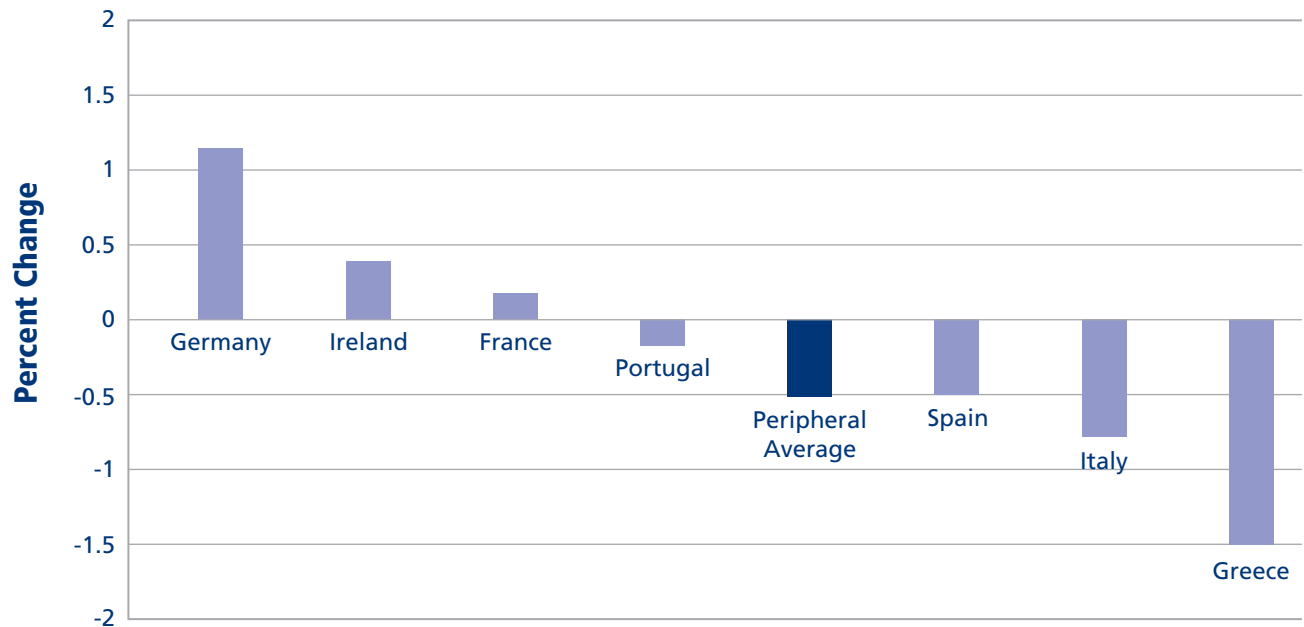
Some have lambasted Europe's tack towards fiscal reform. Influential American economist Paul Krugman referred to European leaders as

"technocrats inducing their nations to accept the bitter austerity medicine; again and again, failing to deliver results."<sup>13</sup> Yet, with peripheral primary deficits in double digits and unit-labor costs over five times those in Germany,<sup>14</sup> *any* recovery path would have required fiscal recalibration.

Spanish firms would not offer full-time employment while facing excessive severance costs. Greece could never be fiscally solvent without increasing tax revenue. Italy could not hope to flex a growth muscle while bound by rigid labor markets. Even in France, if public spending is to come down from a whopping 57 percent of national output,<sup>15</sup> then perhaps the retirement age will need to increase from 60 to 62. Just as in Latin America, a measure of austerity was undoubtedly necessary.

But alone, it cannot solve the crisis. Even the IMF, once a crusader wielding a righteous blade at scurrilous budgets,

## Per Capita GDP Growth, 2008 – 2017 Constant Prices (Estimate 2012 – 2017)



Source: IMF Data

now acknowledges the error of pounding austerity into a recession. In October 2012, the Fund's chief economist, Olivier Blanchard, co-authored an appendix ("box") in the biannual World Economic Outlook that challenged conventional wisdom on the matter. Previously, economists had gauged short-term fiscal multipliers, which measure the ratio of change in income to government spending, at roughly 0.5. This assumption implied that government spending made little impact on growth. Blanchard's analysis suggested a multiplier of up to 1.7. These findings have led the IMF to discourage harsh austerity during times of recession and to recommend spreading fiscal reform over time while simultaneously pursuing growth.<sup>16</sup>

### Austerity Alone Can Prolong the Crisis

If Latin America is any indicator, the concentrated focus on austerity with only lip service paid to growth could, in fact, prolong the debt crisis. Low growth and the stigma of IMF intervention could enforce wide spreads on peripheral debt, perpetuating a "self-fulfilling debt crisis."<sup>17</sup> As Latin America learned, austerity alone simply kicks the can down the road and likely implies subsequent ECB intervention that jeopardizes yet more core-European capital. The ironic lesson appears to be that austerity alone – often the preferred course of creditors – limits the ability of debtors to service loans and to emerge from debt crisis.

Europe now trudges towards the three-year anniversary of realizing "severe irregularities" in Greek public finance still mired in recession. Greek GDP contracted 6.9 percent in 2011, and another six percent in 2012<sup>18</sup> while Portugal has strung together nine successive quarters of contraction.<sup>19</sup> Meanwhile, the Spanish recession has reached five quarters and unemployment now tops 25 percent.<sup>20</sup> As peripheral economies appear reformed but asphyxiated, perhaps Europe must accept a vital lesson from Latin America: Austerity alone cannot solve the crisis.

# LESSON 2: REGAINING COMPETITIVENESS – A RETURN TO GROWTH

## Lesson: If a Country Can Grow, It Can Pay Its Debt

In the early 1980s, Latin American economies were living large on excessive sovereign debt and deficits. Austerity brought these freewheeling economies to a screeching halt. But Latin America needed a return to growth, to pique investor appetite in the region again and to pave the way for debt restructuring. Europe has also used austerity measures to tame out-of-control borrowing and spending. Now, it must re-start the engine.

## Latin America's Re-focus on Growth

By the mid-1980s, Latin American economists realized that the debt burden could not be lifted in a contractionary economic environment. Painful austerity may have been necessary, but Latin America needed a program for the future – not one that just addressed sins of the past. The Baker Plan, introduced by the eponymous US Treasury Secretary James Baker in 1985, did not reverse or rebuke the austerity measures. Rather, the plan argued for growth-oriented policies as the logical next step for countries that had already endured painful adjustments.

History remembers the Baker Plan as a failure – too little done too late. The additional lending attached to the plan proved but a stopgap. Shortcomings aside, however, the Baker Plan re-oriented the conversation from austerity alone and towards a responsible growth model. Perhaps most importantly, the

re-focus originated on the side of debt holders. Latin America *always* would have preferred growth, but the debt holders needed to accept that austerity alone would not repay principal.

## Growth After Austerity – Export Expansion

Export expansion eventually became the logical vehicle for a return to growth. Latin American countries spent much of the 1950s, 60s and 70s constructing formidable trade barriers while nurturing domestic manufacturers. As a result, “state champions” lacked direct competition while insulated currencies led to overpriced exports – two issues of many that undermined international competitiveness.<sup>21</sup>

With a re-focus on growth, however, Latin America would lean heavily on comparative advantages in cheap labor and natural resources to pursue export-led growth. Indicative of the overall policy reversal, Mexico joined the General Agreement on Tariffs and Trade (a precursor to the World Trade Organization) in 1986. Most Latin American nations quickly followed suit.

While countries did not abandon austerity, they did demonstrate a newfound flexibility in pursuit of growth. The Chilean military dictatorship, previously a neoliberal stalwart, actually rolled back on certain Washington Consensus reforms, implementing bailouts, subsidies, credit supplies and technological aid for infant export industries. The plan worked. Chilean GDP

increased at an average annual rate of 6.8 percent between 1985 and 1990 while unemployment fell from 21.4 percent to 5.7 percent.<sup>22</sup> Meanwhile, Chile established itself as a globally relevant exporter of non-traditional goods such as salmon and wine. In the 23 years from 1985 to the global recession of 2008, Chile averaged 8.42 percent *annual growth* in exports,<sup>23</sup> with exports increasing from 21 percent of GDP in 1981 to 42 percent of GDP in 2008.<sup>24</sup> By 2010, the total value of Chilean exports exceeded US\$61.65 billion.<sup>25</sup>

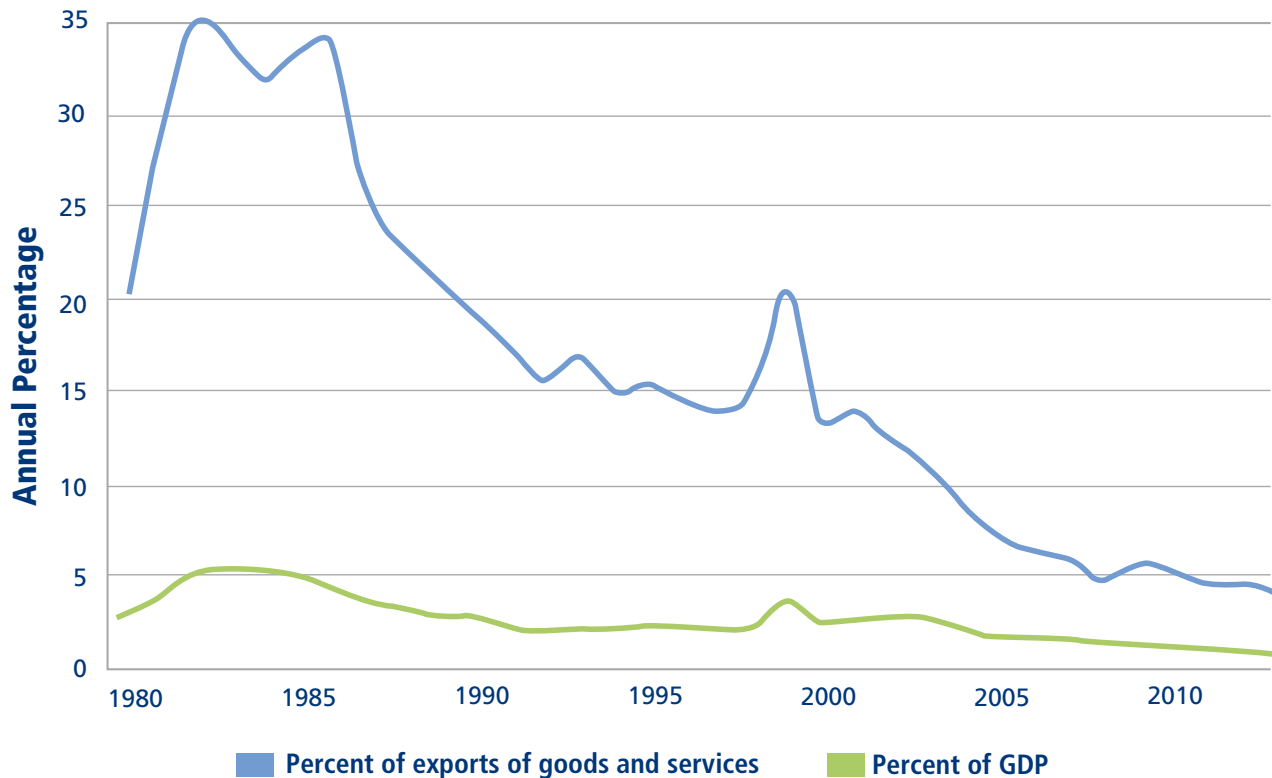
## Monetary Policy: The Value of a Devalue

Currency devaluation is not a panacea, but monetary policy must be part of a growth strategy. In an effort to stimulate exports, nearly all Latin American countries<sup>26</sup> devalued their currencies in the 1980s and early 1990s.<sup>27</sup> Chile entered the debt crisis with a fixed currency established in 1979. Initial austerity required contractionary monetary policy, and the trade surplus flipped to a deficit while GDP plunged 13.6 percent in 1982.

The stiff recession forced Chile to abandon its fixed-exchange rate, and, in mid-1982 an 85-percent devaluation was implemented. This move generated competitive prices for the newly invigorated export sector. New copper mines and cellulose plants dotted the Andes, while vineyards expanded deep into the Chilean heartland.<sup>28</sup>

Tellingly, Chile's return to growth correlated with increased foreign direct

## Latin American Total Debt, Total Debt Service, and Interest



Source: IMF Data

investment (FDI), which moved from a negligible net surplus in the 1980s to a US\$17.3 billion surplus in 2011.<sup>29</sup> Moreover, Chilean external debt has since increased exponentially, yet sustainability has improved dramatically with steep declines in debt-to-GDP ratios. This transition underscores a key fact: The problem was not the debt itself, but rather investors' refusal to roll over the debt. Having returned to growth, Chile became an attractive investment destination.

### What It Means for Europe

The May 6, 2012 election of François Hollande as president of France has re-hashed the austerity-versus-growth debate. Hollande represents a Keynesian faction arguing that Europe cannot cut its way out of crisis. Popular culture portrays him as a boxer squaring off with austerity stalwarts who countered that any fiscal relaxation would undermine what tepid investor confidence has

been generated by austerity. The battle lines between pro-growth populists and austere realists were drawn, with cynical journalists arguing the point moot since neither approach would work anyway.

However, as the Latin American experience suggests, austerity and rekindled growth may not be zero-sum options. Initial reforms have been compared to a necessary but painful operation. If so, the surgery ought not last forever, and the patient must have a rehabilitation plan. The EU has certainly paid lip service to growth, but according to *Der Spiegel*, this has amounted to little more than "hot air" and "accounting tricks."<sup>30</sup> Just as in the early years of the Latin American sovereign-debt crisis, much of the power remains in the hands of debt holders, and, consequently, much of the emphasis remains on fiscal tightening. With the Baker Plan, debt holders finally realized that a re-focus on growth was in their best interest.<sup>31</sup> Core-

Europe debt holders might do well to do the same.

### European Growth After Austerity

The €500 billion question<sup>32</sup> has thus become: How (and where) can Europe generate growth? Abundant in resources and cheap labor, Latin America keyed in on export-led growth. While exports figure to be instrumental in any EU recovery, few member states export substantially to high-growth developing nations. With many members exporting primarily within the eurozone, any export-led growth under the current model would be of the beggar-thy-neighbor variety and would be unlikely to propel the region from crisis.

But Europe, as Latin America, can consolidate strengths. Europe holds comparative advantages in educated labor and mid- to up-market manufacturing. Member states may not

trade intensely with BRICs, but they do trade heavily with developed nations increasingly accustomed to technological enhancement from the boardroom to the bathroom. Core-European economies (in this case including northern Italy) have had far more success exploiting this manufacturing potential. However, peripheral Europe could also be a cost-effective location for skilled manufacturing, especially given recent industry trends towards manufacturing in the developed west.<sup>33</sup>

While Latin America deconstructed barriers to trade to maximize its global advantages, analysts frequently propose that peripheral Europe can deconstruct structural restraints to improve labor-market competitiveness. A number of the proposed reforms, such as reductions to minimum wages, unemployment benefits and job protection, would fall disproportionately upon a vulnerable segment of the European labor market. Moreover, whereas minimum-wage reductions produce clear benefits in microeconomics textbooks, the real-life evidence is far from conclusive.<sup>34</sup>

However, certain structural reforms could help restore growth to Europe. Italy, for example, enjoys a strong industrial base, a large domestic market and a well-educated workforce. Yet the country has struggled to respond to the euro crisis owing to a rigidly constrained labor market. The World Bank's *Doing Business* study found Italy to be an inordinately difficult location to start a business and to obtain construction permits (averaging 234 days and costing 184.2 percent of per capita GDP). The study found it easier for a business to get electricity in Fiji than in Italy. It is thus little surprise that Italian unemployment has increased annually since 2007, rising from 6.1 percent to more than 10 percent.<sup>36</sup>

Such structural inefficiencies have punished peripheral competitiveness. Bureaucracy and regulations helped drop Italy to 42nd place in the World Economic Forum's annual *Global Competitiveness Report* 2012-13. Greece

slipped to 96th, behind Honduras and Botswana. Minimizing costly and time-consuming regulations could make it significantly easier to do business in Europe and help firms maximize the potential of strong infrastructure and educated workforces in countries such as Portugal and Italy.

Bolstered by greater flexibility, Europe can generate growth through increased service-sector integration within the common market. Services account for 70 percent of EU employment and represent the strongest magnet for regional FDI, yet 94 percent of EU-15 services are consumed domestically (meaning Spaniards consume services from Spanish firms).<sup>38</sup> Opening this market (especially as demographics portend explosive healthcare demands) could generate the competition needed to instigate growth. Until now, bruising political battles featuring straw men and "Polish plumbers" have curtailed this option.

Europe can leverage its experience. As countries from the Far East to the Amazon rapidly urbanize, forward-thinking EU firms will find niches to export know-how. Germany, already a global leader in green energy, has emerged as a lead exporter of solar panels to Brazil. Spain, desperate for growth, could also be a key player in this field. In exporting know-how, Europe can link into emerging-market growth spurts.

### Monetary Policy: A Backdoor Devaluation

Put simply, Latin America wished to increase exports in the 1980s and devalued its currencies to facilitate this effort. Lacking monetary levers, European states cannot unilaterally exercise this option unless they exit the common currency – an option the Bertelsmann Foundation believes would have steep financial consequences.<sup>39</sup> However, the overall region would likely benefit from a weaker euro. A loose monetary policy, or "backdoor devaluation," could stimulate extra-regional exports and add some slack to rigid labor markets.

While the trauma of a failed currency has been scarred into core Europe's collective memory, the current obsession with inflation recalls Don Quixote attacking windmills in La Mancha. Inflation has been far from explosive in the eurozone,<sup>40</sup> but the ECB has twice prematurely raised base rates, each time precipitating nadirs in the recession. A degree of quantitative easing along the lines of that conducted by the US Federal Reserve could generate a productive backdoor devaluation of the euro. Such a policy is especially important *because* individual states lack their own monetary levers. With only fiscal tools available, ECB inaction could force desperate nations into revising fiscal policy, thus reversing any gains from austerity.

Hyperinflation was, of course, a characteristic of many Latin American economies in the 1980s. This inflation generally stemmed from printing currency to cover deficits. This would not be the purpose of looser eurozone monetary policy. For Europe, a marginally higher inflation target could incentivize private-sector spending, help address the debt overhang and not be a mechanism to cover deficits.

### From Austerity or Growth to Austerity then Growth

If there is any lesson from Latin America, it is that the path does not fork at austerity or growth. Rather, the prudent path follows austerity *then* growth (or austerity *during* growth, as the IMF might have it). As in Latin America, belt-tightening in Europe is non-negotiable. Just as Mexico could not borrow its way out of debt, neither can Spain stimulate itself out of recession. However, once the fiscal reforms are implemented, growth must be restored to avoid the downward spiral that sank Latin America and appears capable of doing the same in Europe.

# LESSON 3:

## A GOOD HAIRCUT – SUCCESSFULLY STRUCTURING A DEFAULT

### Lesson: After “Austerity then Growth”, Debt Restructuring Can End the Crisis

Default. The word, eschewed by policymakers in public, conjures chaotic images. Perhaps a nationalistic firebrand assumes leadership in a peripheral country and renounces austerity, forcing the IMF to withhold bailout funds. Imagine a disorganized currency exit: a plummeting drachma, escudo or peseta. Envision speculators turning against other peripheral European countries, spreads widening and the dominoes beginning to fall as in East Asia in 1997.

But that is not how the 1980s debt crisis ended. Rather, a market-friendly debt-swap program – though representing a sizeable write-down for creditors – facilitated Latin America’s return to growth and a return of capital. Named after US Treasury Secretary Nicholas Brady (1988 – 1993), the Brady Plan has been cited by some as the cure for the Latin American debt crisis. Other sources find the plan inconsequential in the financial herd’s return to the region. The truth lies in the middle. To step into a new future, Latin America needed to break from its past.

The Brady Bond model was at one point heavily debated in Europe, yet momentum for the approach petered out, perhaps lost in the cacophony of competing ideas. This is unfortunate: The Brady Plan offered a structured default that allowed Latin America to ease the debt burden and return to growth without being shunned by

international capital markets. Europe should take notes.

### The End of the Latin American Debt Crisis

The years of austerity forced necessary fiscal consolidation, and the re-focus on growth helped Latin America close ranks around comparative advantages. These maneuvers prepared the new world to step into the future, but the debt overhang kept it bolted to its past. Rising interest rates were “dead weight on economic activity, paralyzing investment until it could be eradicated.”<sup>43</sup>

Latin American countries established primary surpluses, but debt-servicing costs wiped the nominal balance into deficit.<sup>44</sup> Any growth generated by reforms was promptly shipped overseas as interest payments. With regional debt more than three times the value of total exports,<sup>45</sup> how could Latin America even begin to pay off principal? Without addressing the overhang, the region could not grow. Without growth, investors remained skeptical, banks would not lend and the debt crisis trudged on.

Much like Diego Maradona, by the end of the 1980s Latin America needed a haircut.

Though technically a default, the debt reduction needed to be executed to avoid banishing the region from international credit markets. Rather, the default needed to facilitate the return to growth. The 1989 Brady Plan offered the framework for such debt restructuring,

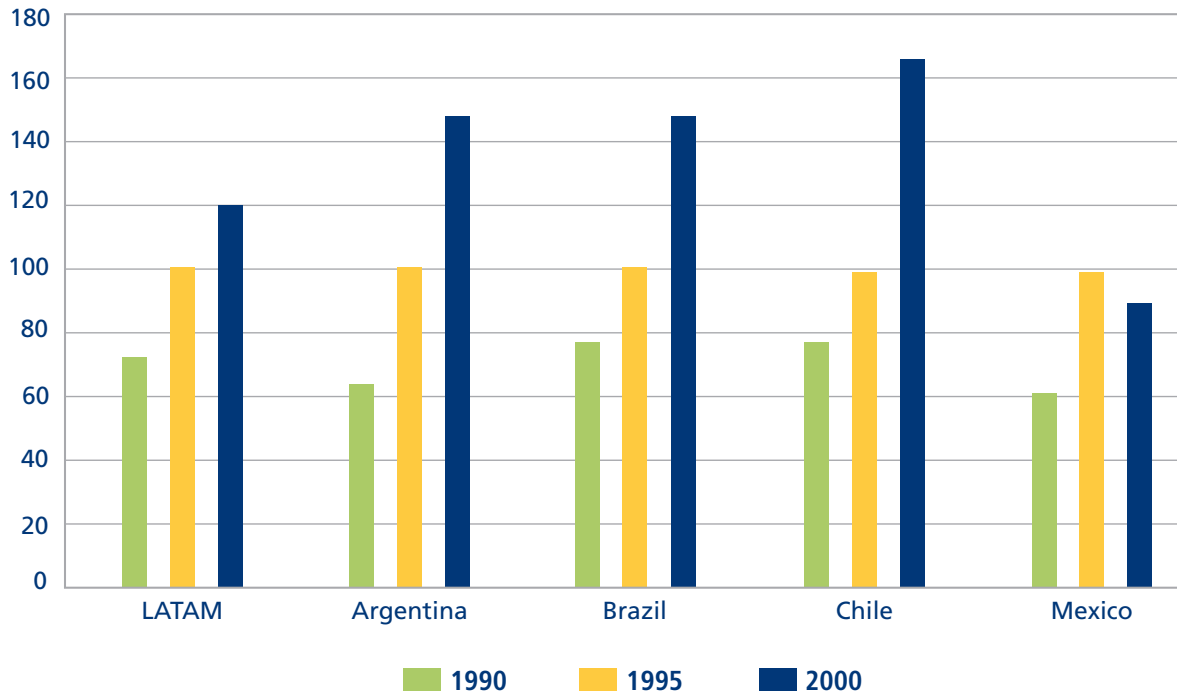
and, while not the sole cause, it immediately preceded significant re-investment in the region.

The Brady Plan allowed banks to convert non-performing or distressed loans into bonds – a fungible commodity that could be sold back to issuing governments or traded on a secondary market. These “Brady Bonds” included value writedowns (paying 65 cents on the dollar in Mexico or 16 cents on the dollar in Costa Rica). But the bonds offered holders different mechanisms for these writedowns, including discounted cash buy-backs, discounted exchanges, asset swaps and securitization of discounted debt.

The scheme proved popular. Anxious to rid themselves of loans unlikely to be repaid, more than 90 percent of Mexican debt holders opted for the voluntary trade-ins by 1990, generating a Mexican sovereign haircut worth over US\$14 billion, 29.8 percent of outstanding debt. Brady Bonds generated similar savings in Argentina (US\$6.28 billion haircut, 32.5 percent of total debt), Uruguay (US\$425 million, 26.4 percent) and Venezuela (US\$3.79 billion, 19.2 percent).<sup>48</sup>

The beauty of Brady Bonds was that they facilitated Latin America’s return to capital markets. The Brady Plan offered an exit to investors fed up with the region while paving a path to growth for investors who wanted to stay in by alleviating the overhang. Meanwhile, Brady Bonds offered an intriguing new investment mechanism in a market that had frozen to a near standstill through

## Latin American Debt (1995 = 100)



Source: IMF ECLAC

the 1980s. With bullet maturities safeguarded by matching US Treasury notes, the Brady Bonds enhanced creditworthiness, and thus the market required lower rates of return.

Brady Bonds did not eliminate Latin American debt, but debt in itself may never have been the problem. In fact, the early 1990s featured rapid investment in Latin America that generated an overall *increase* in debt. These hot money investments proved mismatched and ultimately deleterious,<sup>49</sup> but the fact remains that a decade-long trend of capital outflow had been reversed. Argentina, Mexico, Venezuela and Brazil (large countries that pursued the Brady Plan) together averaged four percent annual growth from 1990 to 1994 while combined external debt in these countries actually increased 26 percent. Investors attached little stigma to Brady countries, and, in 2005, Brazil successfully issued US\$1.44 billion in bonds denominated in domestic *reais*.<sup>50</sup>

### For Europe, Le Brady Plan?

Economists might call it restructuring; investors could call it a haircut. Media might name it after its founder, as they did with Brady Bonds. Central bankers could call it amicable; politicians will call it voluntary. The bottom line with bond swaps is that creditors receive less than they were promised. Euphemisms abound, but at heart it is a default.

There are good reasons that countries avoid defaulting, not least of which is subsequent pariah status in international capital markets. There are good reasons that bond holders avoid “voluntary restructuring”, not least of which is significant losses on existing investments. In the 1980s, Citibank<sup>51</sup> muddled through five years of the Latin American debt crisis before concluding that 35 cents on the dollar was better than zero cents on the dollar.

The Brady Model was initially proposed in Europe and subsequently overlooked,

most likely for the aforementioned issues. Has the time come for Europe to reconsider the notion and to accept a similar haircut on peripheral European debt? Or must the global economy suffer five years of core Europe’s chasing the fantasy of full payment? If the Latin American debt crisis is any indication, the longer the EU procrastinates, the more the debt overhang will grind on economies, putting steep pressure on the same European banks reluctant to accept a haircut.

There is, of course, precedent for a European swap program. In March 2012, Greece successfully engaged more than 86 percent of private credit holders in a 53.5 percent haircut on US\$234 billion in outstanding bonds.<sup>52</sup> Major institutions, including Deutsche Bank and Allianz, accepted the “voluntary” exchange. This particular model would not likely be applicable throughout vulnerable Europe,<sup>53</sup> and its retroactive collective action clause (CAC) would



not be considered “market friendly”. But the swap did suggest that an exchange was possible.

While peripheral European debt-to-GDP ratios exceeding 100 percent are clearly hard to defend, the Latin America experience suggests that the problem is not necessarily the debt itself but rather the frozen capital markets. By transitioning bank loans to bonds, the Brady notes added sorely needed liquidity to an arid market.

While much of European debt is already issued in fungible bond form, an exchange program could still add liquidity to issuances rotting in (and weighing down) European banks. New York University economists Nicholas Economides and Roy Smith present a “Trichet Bond”, collateralized by zero-coupon bonds issued by the ECB. Existing holders would trade in their underperforming bonds for Trichet Bonds of longer duration and at current market value (as opposed to original par value).<sup>54</sup>

ECB collateralization would offer heightened security, while a longer tenor would postpone significant quantities of looming peripheral debt, thus softening the immediate crisis of uncertainty that has pushed premiums to unsustainable heights.<sup>55</sup> The sales pitch would offer investors a trade of quality for quantity (in terms of returns). As with Brady Bonds, the enhanced creditworthiness of the new notes would likely put downward pressure on interest rates.

The €500<sup>56</sup> billion question becomes: Would European bond holders (often banks) accept such a trade-in? The Latin American experience suggests that part of the answer will stem from Europe’s ability to demonstrate growth potential. By 1990, Latin America had established a plausible path towards growth, and investors saw it in their interest to shed the debt overhang.<sup>57</sup> For European banks, the trade would offer the additional advantage of clearing out vulnerable credit that clouds any ability to evaluate recapitalization efforts.

In a policy brief for the Inter-American Development Bank, Eduardo Cavallo and Eduardo Fernández-Arias note that with the advent of Brady Bonds, markets again became “forward looking... recognizing that the new regime emerging with the cleanup offered good business opportunities for both foreign direct investment and portfolio flows.”<sup>58</sup>

Europe remains mired in the “mess” phase. With significant capital tied up in peripheral debt, core-European banks are still hesitant to accept haircuts on their investments. American commercial banks shared this hesitancy in the 1980s, trudging through a decade before accepting the inevitable writedowns. The reluctance may be understandable, but Latin American history suggests that structured, preemptive action is preferable to a messy default under duress.



# LESSON 4: DRAWING THE RIGHT CONCLUSIONS FROM ARGENTINA

## Lesson: Europe has much to learn from the Argentine default of 2001, but the soundest takeaways are often not the most obvious.

Given the similarities between millennium-era Argentina and today's Greece, as well as Argentina's apparent post-crisis success, some wonder if a Greek default and currency exit might not be the worst option for Athens.<sup>59</sup> However, Argentina's "recovery" would not easily be replicated, and the Argentine model should by no means be considered a blueprint for Greece. This lesson argues that Europe has much to learn from the Argentine default of 2001, but the soundest takeaways are often not the most obvious.

### A Messy Default, A Swift Recovery

In 2001, Argentina suffered the proverbial "messy default". Ten years earlier, the country had legally pegged one peso to one American dollar in an effort to curb hyperinflation. Known as "convertibility", the scheme enjoyed tremendous initial success as Argentina issued billions of dollars in international bonds. By the turn of the century, however, macroeconomic forces overwhelmed attempts to defend the peg. To the tune of protesters banging pots and pans throughout the streets of Buenos Aires, Argentina was forced to disband the currency board.

Many of the deepest fears forecasters share over a chaotic Greek eurozone exit (a "Grexit") occurred in Argentina. The

newly untethered peso plummeted to a quarter of its pegged value, representing massive losses for Argentines who owed debt in dollars. Political instability led to a revolving door on the executive's office, with three presidents occupying *La Casa Rosada* over a two-week span. Confrontations in the streets left scores dead as Argentines famously chanted "*Que se vayan todos!* (Everybody out!)" at their government.

Over the next eight years, however, something odd happened. Despite pariah status in the international capital markets, Argentina began to grow – rapidly. After suffering a 10.9 percent GDP contraction in 2002, Argentina posted growth rates of 10.5, 9.0, 9.2 and 8.5 percent from 2003 through 2006, and would go on to average 5.91 percent annual GDP growth in the decade immediately following the largest-ever sovereign default.<sup>61</sup>

A cursory analysis suggests that despite a messy exit, or perhaps *because* of the messy exit, Argentina regained a degree of competitiveness and quickly re-established growth rates that peripheral Europe would welcome. Could Argentina's rebound be a blueprint for Greece?

### A Suboptimal Blueprint

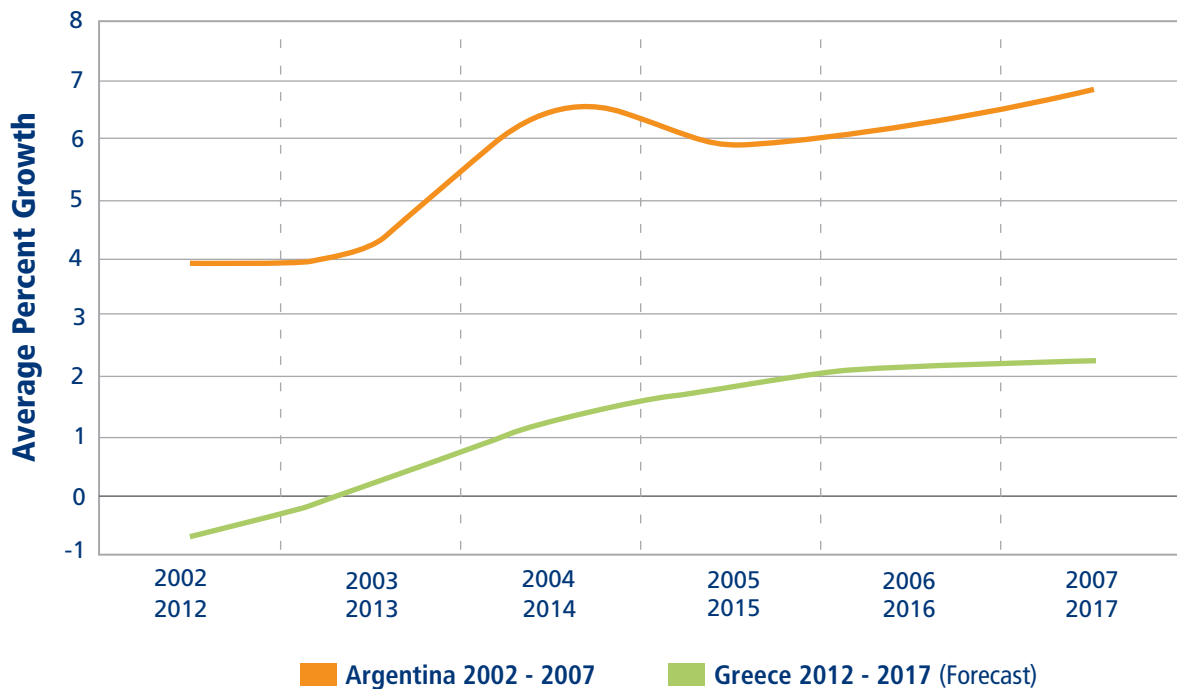
While there may be strong similarities,<sup>62</sup> Argentina does not offer a blueprint for Greece. Argentina's recovery exploited particular circumstances that would not easily be replicated by Greece. An agricultural powerhouse, Argentina began its renaissance just as Chinese

demand for commodities exploded. Argentine export prices spiked (soy values increased from roughly US\$180 per ton in 2001 to US\$500 per ton in 2011) as did volumes (Argentine soy exports doubled from 1998 to 2008), generating windfall profits for farmers from La Pampa to Patagonia.<sup>63</sup>

The commodity boom portended overall Argentine trade expansion to high-growth regions. In 2003, the first year of the Argentine recovery, total exports to China more than doubled from US\$1.24 billion to US\$2.73 billion. The next year they increased by 20 percent and the year after that by 17 percent. By 2008, Argentine exports to China topped out at US\$9.36 billion, or 754 percent of the 2001 value.<sup>64</sup> The devalued peso may have facilitated increased trade. But it was high growth and high demand from the Far East, the Middle East and neighboring Brazil that gave Argentina significant room to expand.

Group walking tours of Santorini aside, Greece does not offer exports of either great value or demand to rapidly developing economies such as China. In fact, none of Greece's top three export destinations – Germany, Italy and Cyprus – are forecast to grow more than 1.7 percent between 2011 and 2015.<sup>65</sup> Even areas of potential export growth face obstacles. International tourists, for example, might be intrigued by cheaper holidays but put off by political and social unrest. Furthermore, whereas Argentina enjoyed extensive fertile plains for agricultural expansion, it could take years to adequately expand

## Average Growth of Top Four Major Trade Partners



Source: IMF Data

Greece's tourist capacity, where such expansion is possible.

The Bertelsmann Foundation forecasts that a Greek exit would provoke financial crisis, followed by a prolonged eurozone downturn.<sup>66</sup> Bertelsmann Foundation, along with Prognos AG has determined that such a scenario would induce total losses of €674 billion on the world's top 42 economies. Such an economic malaise would undermine any ability to realize the fruits of a devalued currency. Greek exports might well be cheaper, but depressed eurozone consumption would limit gains. Argentine-levels of growth will not be won by selling cheap olives to countries in recession.

### A Suboptimal Recovery

Since the early days of Néstor Kirchner's presidency (2003 – 2007), many have predicted the imminent collapse of the Argentine economy. Ten years later, no such collapse has occurred. Attributing Argentina's rebound from crisis solely

to dumb luck and China would be to underestimate the Kirchners – something that Argentines inside and outside of the *Partido Justicialista* have learned can be dangerous.

Nevertheless, it's hard to imagine the policymaker who would wish an Argentine-esque recovery for his own country. Argentina is still a financial pariah. It has pushed the US Treasury to its wits' end. The IMF has publicly censured the country, while *The Economist* no longer recognizes the government's dubious financial statistics.

### With protests mounting in Buenos Aires, even Argentina is frustrated with Argentina.

Under current President Cristina Fernández Kirchner, who succeeded her husband in 2007, fiscal spending has again become a primary strategy to maintain mass support. She has expanded pensions and increased

welfare benefits. Yet, in contrast to Brady Bond countries, Argentina cannot access international capital, thus challenging the ability to finance *any* deficit.<sup>67</sup> Argentina has resorted to capital controls and bizarre import-export regulations that leave car manufacturers exporting wine and regular citizens waiting longer to buy imported goods at steeper prices.

Meanwhile, inflation is estimated at more than 20 percent, and, as of early 2012, capital was flowing out of the country at a pace of US\$2 billion per month. Subsequent currency controls may have stemmed some of this outflow, but they have also engendered an overvalued peso. The current-account surplus – the same surplus required to finance fiscal expansion – is dwindling.

Perhaps a collapse is imminent. More likely, the Fernández government will ride agricultural and hydrocarbon exports to at least stay afloat. Either way, the Argentine economy is not

exactly a paradigm of recovery. Lacking Argentina's one saving grace (traditional commodities), a wholesale Greek default is unlikely to offer a more stable rebound.

### Suboptimal Currency Zone

In legally pegging the peso to the US dollar, the Argentine "convertibility" program offers a fascinating experiment of a "monetary union" with zero fiscal integration. With asymmetric demand shocks, divergent growth rates, differing inflation expectations and completely distinct legal systems, Argentina and the US fail just about every traditional measure of an optimal currency zone.<sup>69</sup>

To a certain degree, so too do California and Kentucky. Riding the tail end of the dot-com boom, California posted 8.88 percent growth from 1999 to 2000. In contrast, Kentucky contracted 0.29 percent during that year, while neighboring West Virginia grew a paltry 0.9 percent.<sup>70</sup> If independent, all three may have chosen different monetary policies – something the centralized Federal Reserve Bank precludes. However, the fiscally integrated federal system had a redistributive effect that smoothed inequalities. On a per capita basis, federal tax revenue exceeded federal spending for *each* Californian by \$2,964 in year 2000. West Virginia, on the other hand, received a per capita surplus of \$2,368; Kentucky, a per capita surplus of \$920.<sup>71</sup> This not to imply that life was all peaches and growth in West Virginia. But the redistribution eased the regional inequalities. The US grew 4.9 percent in 1999 and 4.2 percent in 2000 – by all accounts good years.

The Argentine economy contracted by 3.4 percent in 1999 and 0.8 percent in 2000. However, unlike Kentucky, there would be no fiscal redistribution. When the Mexican government falters, the US may step in, given the financial and social consequences of economic chaos south of the border.<sup>72</sup> When Argentina stumbled in 2001, it was lucky to get a message of condolence from Uncle Sam.

In his highly regarded text on monetary unions, Paul de Grauwe writes that countries facing asymmetrical shocks in a monetary union that lacks fiscal mechanisms can resort to debt – essentially intergenerational redistribution.<sup>73</sup> There may well have been a capital surplus in the US in year 2000, but at that point, it surely was not going to finance Argentine debt. Thus we arrive at a key lesson: Suboptimal currency unions without fiscal redistribution are and remain highly vulnerable to a debt crisis. Argentina could not hold the peg, and the resultant financial storm washed away billions of dollars in savings.

The EU is famously caught in the middle, with a shared currency but a miniscule centralized budget. With the spread between 2011 German and Greek growth at more than 10 percent, Greece would appear to need some redistributive mechanism to counter a lack of monetary levers. Yet with Greek debt at over 150 percent of GDP, it can no longer afford to redistribute from the future.

The European monetary union has arrived at a crossroads between deeper integration and dissolution. The Bertelsmann Foundation forecasts economic havoc upon any dissolution, but this is what inaction might force. EU leaders appear to understand the urgency of fiscal integration, scheduling a series of talks, as is their wont. The European Fiscal Compact aims to enforce budgetary norms across the region. Time will tell whether this is an improvement on the Growth and Stability Pact of 1998-1999 and a stepping stone to a fiscal union. Yet many political battles remain.

Thus, the Argentine case offers key lessons – just not the ones espoused by commentators who view the South American country's experience as a blueprint for Greece. Rather, the crucial differences suggest that a post-exit Greece would not match Argentine growth of recent years. The Argentine economic model remains flawed, and growth is sustained by Chinese

demand – an outlet unavailable to Greece. The Argentine experience also exposes the fundamental instability of a suboptimal currency zone that lacks a fiscal mechanism. For Europe, better to take Messi, and not messy default, from Argentina.

# LESSON 5: BEWARE OF THE BACKLASH

## Reform Fatigue Can Create a Political Backlash that Undermines Change

In November, the backlash to externally imposed austerity again boiled over. Labor unions executed coordinated strikes. University students took to the streets. Daily life came to a halt as citizens protested grinding reforms. The harsh economic restructuring was demanded by the IMF and backed by the regional hegemon as conditional for assistance needed to survive a sovereign debt crisis. The protests soured, leading to hundreds of arrests, a handful of deaths and sporadic rioting.

This story may seem familiar. But it does not refer to the November 14, 2012 austerity protests that shook Madrid, Rome and Lisbon. Rather, these November protests occurred in 1991. And they occurred on the other side of the world, in Venezuela.

In comparing Latin American and European debt crises, scholars and policymakers focus almost uniformly on the economics – how to structure a haircut, for example, or, perhaps, the utility of a currency devaluation. With opposition mounting on European streets, the political lessons from Latin America may prove equally salient.

## Whiplash: The Washington Consensus and the New Latin American Left

Within three months of those 1991 protests, a young army officer named Hugo Chávez would stage a coup against the pro-IMF Venezuelan government. The

coup failed, but the popular backlash would continue, eventually ushering Chávez to power in 1999. He proceeded to entrench his anti-austerity philosophy in government policy.

In the 1980s and 1990s, nearly all Latin American countries turned to the IMF for relief. To satisfy preconditions for assistance, many of these countries adopted structural reforms devised by the IMF and the US Treasury Department.

These reforms, featuring trade liberalization, privatization and labor-market flexibility, reflected developed-world prescriptions for ailments to Latin American economies. Countries throughout the region adopted these policies, mostly to maintain access to official funding and international capital markets.

Known collectively as the “Washington Consensus”, these neo-liberal economic reforms were all but forced upon Latin American countries. Proponents of the consensus argue that the tenets were only employed half-way; that Latin American governments tackled the easy reforms, but avoided more difficult systemic changes. These proponents cite Chile as the Washington Consensus’ best pupil, and suggest that it is no coincidence that the Andean country is now knocking on the door of developed-nation status.

These proponents have a strong argument. However, political momentum is often as much about feel as it is about fact. Perhaps the Washington

Consensus was the correct approach; perhaps the region would be better off had it accepted the full depth of the philosophy. However, the *feeling* turned against the consensus. Eventually the imported policies provoked a backlash as many citizens ultimately rejected an economic approach imposed in a moment of weakness by more powerful agents.

This distaste helped sweep a series of left-leaning politicians to power at the turn of the 21st century. From 1999 to 2006, nearly all major Latin American elections featuring two candidates went to the one further to the left. The South American countries that experimented most aggressively with Washington-oriented reforms are precisely the countries that have since drifted furthest to the left. In Venezuela, Argentina and Bolivia, once poster children of the Washington Consensus, voters have persistently preferred presidents who have promised to roll back neoliberal reforms. In Chile, another Consensus-stalwart, voters supported twenty consecutive years of center-left Concertación government.

## What it means for Europe

Washington-based organizations such as the IMF, the World Bank and the US Treasury pushed aggressively for a certain set of reforms in Latin America. Owing to the backlash, a number of Latin American countries have now adopted policies diametrically opposed to those espoused in the American capital. This is a valuable lesson for Brussels and Berlin.

## Reform Fatigue

### South America 1995

Governments favorable to Washington Consensus reforms.



### South America 2010

Countries where executive ran on a more statist platform than the incumbent or primary challenger.



- Heritage Foundation Index of Economic Freedom declined between 1995 – 1998
- Heritage Foundation Index of Economic Freedom improved between 1995 – 1998

- Heritage Foundation Index of Economic Freedom improved between 1998 – 2010
- Heritage Foundation Index of Economic Freedom declined between 1998 – 2010

\* The degree of reform and backlash varies by country. For example, Chile's Michelle Bachelet won on a center-left coalition in 2006, yet her government largely followed the liberalization script. Scholars have used the Heritage Foundation Index of Economic Reform as a proxy for adherence to the Washington Consensus. A higher score suggests greater economic liberalization.

\* Peruvian President Alan García (2006 – 2011) ran to the left of outgoing President Toledo, but to the right of runner-up Ollanta Humala

\* Guyana, Suriname and French Guiana are not considered

Like Latin America, peripheral Europe initially accepted the international prescription for solving the debt crisis. Just as Washington Consensus-styled leaders assumed power in Latin America in the 1990s, so too have “Brussels Consensus” leaders taken the helm

throughout debt-ridden Europe. From the Iberian peninsula to the Aegean Sea, a new crop of European leaders has emerged prepared to implement fiscal austerity and structural reforms, just as core Europe and the IMF have demanded.

However, if Latin America is any indicator, Europe's persistent stagnation and high unemployment rates could prove fertile ground for a backlash against reform. In fact, throughout peripheral Europe, the notion that austerity has been foisted upon them by outside organizations

such as the IMF, or countries such as Germany, has given rise to nationalistic movements that reject restructuring.

In Greece, anti-austerity candidate Alexis Tsipras came within three points of winning the power to form a government in Athens. In Italy, support for Mario Monti's Brussels Consensus-styled government dropped from 54 percent in November 2011 to 32 percent in November 2012, and in the Italian general elections of February 2013, the man who injected a degree of seriousness into Italian politics was trounced at the ballot box. Disinterest in traditional parties marked the run-up to those elections, and the initial results left only one thing clear: "Italian voters delivered a rousing anti-austerity message and a strong rebuke to the existing political order," wrote *The New York Times*.<sup>75</sup>

In Spain, the austerity backlash has threatened the integrity of the nation as Catalonia has demanded independence rather than continue under Madrid-led reform. The French electorate replaced austerity-stalwart Nicolas Sarkozy with François Hollande in 2012. The crisis has also strengthened nationalist movements in core Europe, appealing to French and German segments less committed to the European project.

Throughout peripheral Europe, austerity fatigue appears to be gaining momentum. Perhaps, for these countries, the dismantling of cherished safety net provisions and worker protection will provoke the backlash that privatization caused in Latin America. Perhaps grinding austerity will lose its appeal as a necessary adjustment; perhaps public opinion will coalesce around the notion that the Brussels Consensus is a foreign

import forced upon their countries in a moment of vulnerability.

Perhaps, if the lessons from Latin America go unheeded, such a backlash will push politicians such as Syriza's Alexis Tsipras over the edge and into the electoral mainstream. As Hugo Chávez's experience illuminates, the tide may not turn immediately, but it can turn definitively. As long as Europe has paused to consider the economic lessons of the Latin American debt crisis, it would do well to consider also the potential political lessons.

# EUROPE BEYOND THE STATUS QUO

This paper has drawn a coherent narrative from a Latin American debt-crisis response that was, for the most part, disjointed and uncoordinated. Latin American and US leaders eventually accepted that growth must be a part of the recovery process, not just a biannual conference topic. A return to growth jumpstarted stagnant economies, while a market-friendly haircut slayed the debt overhang. While far from a linear recovery, a number of governments that pursued this approach have since enjoyed reasonable growth and development rates, while becoming respected members of the international financial community.

Europe's task today can appear more daunting. The EU cannot easily generate the rapid growth rates characteristic of emerging markets. Moreover, peripheral European debt-to-GDP ratios are, in some cases, double the debt burden of Latin American countries in the 1980s. The combination of rapid growth and more manageable overall debt helped Latin America rapidly settle outstanding IMF accounts. Such a short turnaround will be unlikely for peripheral Europe.

But Europe also has opportunities that were unavailable to debt-ridden Latin America, such as the potential for increased integration. A more cohesive EU could address many of the lessons from Latin America. An expanded ECB mandate, with increased emphasis on employment, could promote a monetary policy more appropriate for the entire region. Deeper financial and service-sector integration could bolster regional growth and consumption. A fiscal component to the monetary union would smooth inequalities and, in turn, protect peripheral consumption of core exports.

Certainly, lessons from Latin America suggest that the status quo is unsustainable. In the early 2000s, frustration with Washington Consensus reforms led to a populist backlash from Ecuador to Argentina. Austerity without growth will result in a similar Brussels Consensus backlash in Europe. Nationalists in core Europe will rail against supposedly indolent southerners more concerned with siestas and government benefits than reform. Meanwhile, counterparts in peripheral Europe will demand the removal of repressive economic policies enforced by the powerful core. As the crisis trudges on, both arguments will find increasingly receptive audiences. Such a backlash, replete with unfortunate historical overtones, could result in an erosion of European integration from both sides.

European policymakers who dismiss the lessons of Latin America as remote chapters from an underdeveloped continent may be overlooking answers to a sovereign-debt crisis crawling into its fourth year with no end in sight. The European experiment appears stuck at a treacherous crossroads. The Latin American experience of the 1980s offers a roadmap for recovery. Will anyone bother to read it?



# ENDNOTES

- <sup>1</sup> At the time referring to a currency (usually American dollars) held outside of its country of origin
- <sup>2</sup> Source: IMF Database. Available online at [http://www.imf.org/external/pubs/ft/weo/2012/02/weodata/weorept.aspx?sy=2000&ey=2012&scsm=1&ssd=1&sort=country&ds=.&br=1&c=182%2C174%2C184&s=GGXWDG\\_NGDP&grp=0&a=&pr.x=76&pr.y=20](http://www.imf.org/external/pubs/ft/weo/2012/02/weodata/weorept.aspx?sy=2000&ey=2012&scsm=1&ssd=1&sort=country&ds=.&br=1&c=182%2C174%2C184&s=GGXWDG_NGDP&grp=0&a=&pr.x=76&pr.y=20).
- <sup>3</sup> Victor Bulmer-Thomas. *The Economic History of Latin America Since Independence*. (Cambridge: Cambridge University Press, 2003), 136 – 152.
- <sup>4</sup> Philip R. Lane. “The European Sovereign Debt Crisis.” *Journal of Economic Perspectives*, Vol. 26, No. 3. Summer, 2012, 54.
- <sup>5</sup> Bulmer-Thomas, 351.
- <sup>6</sup> Bulmer-Thomas, 366.
- <sup>7</sup> ECLAC. *Statistical Yearbook of Latin America and the Caribbean*, 2000. (Santiago, Chile: United Nations).
- <sup>8</sup> Adolfo Figueroa. “Peru: Social Policies and Economic Adjustment.” In *Coping With Austerity: Poverty and Inequality in Latin America*. (Washington, DC: The Brookings Institute, 1995), 375.
- <sup>9</sup> Pedro-Pablo Kuczynski. *Latin American Debt*. (Baltimore: The Johns Hopkins University Press, 1988), 96.
- <sup>10</sup> Bulmer-Thomas, 377.
- <sup>11</sup> Fernanda Nechio. “Long-Run Impact of the Crisis in Europe: Reforms and Austerity Measures.” *Federal Reserve Bank of San Francisco Economic Letter*, 3/7/2011. Available online at <http://www.frbsf.org/publications/economics/letter/2011/el2011-07.html>
- <sup>12</sup> Nechio, 3-4.
- <sup>13</sup> Paul Krugman. “Bleeding Europe.” *The New York Times*, 12/11/2012. Available online at <http://krugman.blogs.nytimes.com/2012/12/11/bleeding-europe/>
- <sup>14</sup> Source: European Commission. See Nechio, 3.
- <sup>15</sup> John Peet. “France: So Much to Do, So Little Time.” *The Economist*, 11/17/2012. Available online at <http://www.economist.com/news/special-report/21566233-france-slowly-heading-towards-crisis-says-john-peat-can-country-be-reformed>
- <sup>16</sup> International Monetary Fund. *World Economic Outlook, October 2012: Coping with high Debt and Sluggish Growth*. (Washington DC: International Monetary Fund, 2012). Also See: Olivier Blanchard and Daniel Leight. “Growth Forecast Errors and Fiscal Multipliers.” *IMF Working Paper* WP/13/1, 1/2013. Available online at <http://www.imf.org/external/pubs/ft/wp/2013/wp1301.pdf>
- <sup>17</sup> Cristina Arellano, Juan Carlos Conesa, Timothy J. Kehoe. “Chronic Sovereign Debt Crises in the Eurozone, 2010 – 2012.” *Federal Reserve Bank of Minneapolis, Economic Policy Paper* 12-4, May 2012. Available online at [http://www.minneapolisfed.org/publications\\_papers/pub\\_display.cfm?id=4898](http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=4898)
- <sup>18</sup> Source: International Monetary Fund Data Base
- <sup>19</sup> Source: Organization for Economic Co-operation and Development Database. Available online at <http://stats.oecd.org/index.aspx?queryid=350#>
- <sup>20</sup> Sources: Organization for Economic Co-operation and Development Database and IMF Database
- <sup>21</sup> By 1980, Latin America’s share of global trade plummeted to 3.5 percent (See Bulmer-Thomas, 385).
- <sup>22</sup> Francisco E. González. *Duel Transitions from Authoritarian Rule*. (Baltimore: The Johns Hopkins University Press, 2008), 99.
- <sup>23</sup> Source: International Monetary Fund Data Base, Chile
- <sup>24</sup> Source: World Bank Development Indicators
- <sup>25</sup> Bertelsmann Foundation, Global Economic Dynamic Visualizer
- <sup>26</sup> Excluding dollarized Panama
- <sup>27</sup> Bulmer-Thomas, 381.
- <sup>28</sup> Erik Haindl. “Chile’s Resolution of the External Debt Problem.” In Robert Grosse, ed. *Government Responses to the Latin American Debt Problem*. (Miami: North-South Press, 1995), 20
- <sup>29</sup> Source: World Bank World Development Indicators
- <sup>30</sup> Carsten Volker. “The Empty Promise of Europe’s ‘Growth Pact.’” *Spiegel Online*, 6/27/2012. Available online at <http://www.spiegel.de/international/europe/the-eu-s-new-growth-pact-a-841243.html>.
- <sup>31</sup> Multinational private banks located in the US, not the US Treasury, held much of the Latin American debt. However, the US Treasury acted with their interests close at heart.
- <sup>32</sup> The additional production required to generate 4 percent eurozone growth



- <sup>33</sup> “Reshoring Manufacturing: Coming Home.” *The Economist*, 1/19/2013. Available online at <http://www.economist.com/news/special-report/21569570-growing-number-american-companies-are-moving-their-manufacturing-back-united>
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- <sup>35</sup> The World Bank. “Doing Business: Measuring Business Regulations, 2013.” Available online at <http://doingbusiness.org/data/exploreconomies/italy/>
- <sup>36</sup> Source: IMF Data
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- <sup>38</sup> John Springford. *How To Build European Service Markets*. (The Centre for European Reform, 9/28/2012) Available online at <http://www.cer.org.uk/publications/archive/policy-brief/2012/how-build-european-services-markets>
- <sup>39</sup> See Theiss Peterson and Ulrich Schoof.
- <sup>40</sup> Eurozone inflation has averaged 2.05 percent annually from 2008 to 2012, and 2.15 percent since year 2000. Source: IMF Data
- <sup>41</sup> Nicholas Economides and Roy Smith. “Trichet Bonds to Resolve the European Sovereign Debt Problem; Working Paper #11-01.” The Networks, Electronic Commerce and Telecommunications Institute, 1/2011. Available online at [http://archive.nyu.edu/bitstream/2451/31380/2/NET%2011\\_01.pdf](http://archive.nyu.edu/bitstream/2451/31380/2/NET%2011_01.pdf)
- <sup>42</sup> See Bulmer-Thomas
- <sup>43</sup> Eduardo Cavallo and Eduardo Fernández-Arias. “Coping with Financial Crises: Latin American Answers to European Question.” *Inter-American Development Bank Policy Brief No. IDB-PB-176*, 10/2012. Available online at [http://www.iadb.org/en/research-and-data/publication-details,3169.html?pub\\_id=IDB-PB-176](http://www.iadb.org/en/research-and-data/publication-details,3169.html?pub_id=IDB-PB-176)
- <sup>44</sup> Bulmer-Thomas, 381
- <sup>45</sup> Kuczynski, 10.
- <sup>46</sup> Diego Aramburú. “Brady Plan for Commercial Bank Debt Relief.” In Robert Grosse, ed. *Government Responses to the Latin American Debt Crisis*. (Miami: North-South Center Press, 1995) 162 – 163.
- <sup>47</sup> Aramburú, 160.
- <sup>48</sup> Aramburú, 162.
- <sup>49</sup> Hot money investments in Latin America led to a new, 1990s form of capital crisis that afflicted Mexico (1994), Brazil (1998) and ultimately, Argentina (1999-2001).
- <sup>50</sup> The September 2005 issuances totaled R\$3.4 billion. This dollar value was derived using the 9/1/2005 exchange rate of .42USD/R.
- <sup>51</sup> With more than US\$10 billion tied up in Latin America, Citicorp was the preeminent lender of the 1980s debt crisis. See Griffith-Jones, Marcel and Palma.
- <sup>52</sup> Joanna Kakissis. “Greek Bond Swap A Temporary Fix.” National Public Radio, 3/9/2012. Available online at <http://www.npr.org/2012/03/09/148317347/greek-bond-swap-a-temporary-fix>
- <sup>53</sup> In Italy, for example, 65 percent of outstanding debt is held domestically, creating different challenges from Greece where only 30 percent was held domestically (see: Lee C. Buchheit and G. Mitu Gulati, *How to Restructure Greek Debt*)
- <sup>54</sup> See Economides and Smith
- <sup>55</sup> Economides and Smith, 1.
- <sup>56</sup> Roughly the value of a 50 percent haircut to 2012 Portuguese, Irish, Greek and Spanish debt. Data from The Guardian Data Blog, 2/6/12. Available online at <http://www.guardian.co.uk/news/datablog/2012/feb/06/europe-government-debt>
- <sup>57</sup> See Cavallo and Fernández
- <sup>58</sup> See Cavallo and Fernández
- <sup>59</sup> Aaron Katsman of the popular online financial magazine Seeking Alpha writes. “Instead of [Greece] punting the problem down the road another three or four months, why not just admit the truth: declare bankruptcy and start fixing the problems like Argentina?” (See Katsman) Larry Elliot of The Guardian agrees, stating, “Argentina provides the template [for Greece] as a country that defied the doomsters and made a go of life after devaluation and default,” (See Elliot) while renowned global economist Nouriel Roubini cites Argentina as part of his encouragement for Greece to leave the Euro (See Fontevéchia). These arguments almost seem to suggest that Greece is but a few bad days for the drachma away from 9 percent annual growth.
- <sup>60</sup> Fernando de la Rúa (12/10/1999 – 12/20/2001), Adolfo Rodríguez Saá (12/22/2001 – 12/30/2001), Eduardo Duhalde (1/2/2001– 5/25/2003).
- <sup>61</sup> Source: *The World Bank*, World Development Indicators.
- <sup>62</sup> Both Argentina and Greece had long histories of monetary instability. Both eased investors’ nerves by pegging their currencies to that of stronger, more reliable countries. Both reaped immediate benefits, accessing spigots of capital at a low cost. Eventually, both found themselves hemmed in by a suboptimal currency zone. Like Greece today, Argentina slugged through recession in the late 1990s, while its currency remained strong. Like Argentina, Greek policymakers have (generally) been steadfast in their commitment to the currency union while underwhelming “fixes” increasingly portend dissolution as public frustration simmers.
- <sup>63</sup> [http://www.taskforcesustainablesoy.org/index.php?option=com\\_content&task=view&id=27&Itemid=](http://www.taskforcesustainablesoy.org/index.php?option=com_content&task=view&id=27&Itemid=)
- <sup>64</sup> Bertelsmann Foundation, Global Economic Dynamics Trade Statistics.
- <sup>65</sup> Bénédicte Kukla, Isabelle Job and Robin Mourier. “Greece vs. Argentina: Looks Can Be Deceiving.” *Credit Agricole S.A.*, December 2011. Available online at <http://economic-research.credit-agricole.com/site/greece-vs-argentina-looks-can-be-deceiving-1496.html>
- <sup>66</sup> Recent findings by Bertelsmann Stiftung’s Global Economic Dynamics (GED) team forecasts the consequences of an Argentine-styled Greek eurozone exit (Grexit) (See: Theiss Peterson & Ulrich Schoof. “Economic Impact of Southern European Member States Exiting the Eurozone.” Bertelsmann Stiftung Policy Brief #2012/06, 10/17/2012).

Using a sophisticated prognostic model, the GED team forecasts that, in the event of a Grexit, Greece would face a cumulative GDP decline of 164 billion euros from 2013 to 2020. This decline would increase to 174 billion euros should the Greek exit be succeeded by a general eurozone breakup, in which Portugal, Spain and Italy exit as well.

In the Bertelsmann GED Team's simulations, a number of the Grexit assumptions mirrored what occurred in Argentina. For example, the GED team forecasts that a Greek default would lead to a significant haircut, as occurred in Argentina. The model is also predicated on any new Greek currency facing a 50 percent devaluation upon introduction – if anything, a conservative estimate compared to what happened in Argentina. The model even uses the Argentine experience to quantify potential losses stemming from decreased consumer investor confidence.

Essentially the model uses Argentina as a template for a Grexit, just as pundits such as Nouriel Roubini recommended. However, instead of an economic rally, the study forecasts steep declines in annual GDP, only to be followed by years of recession.

<sup>67</sup> Argentina did issue Brady Bonds, and thus, was once a “Brady Bond country.” This argument contrasts post-2001 Argentina with Brady Bond countries that did not experience a second, messy default.

<sup>68</sup> Argentina did make efforts to streamline certain procedures with US expectations. For example, millions of dollars in bonds were issued under United States law – a move that would have legal ramifications to this day. Overall, however, the American and Argentine legal systems remain overwhelmingly distinct.

<sup>69</sup> Paul De Grauwe. *Economics of Monetary Union*, Eighth Edition. (Oxford: Oxford University Press, 2009), 1 – 106.

<sup>70</sup> U.S. Department of Commerce, Bureau of Economic Analysis. Available online at <http://www.bea.gov/iTable/drilldown.cfm?reqid=70&stepnum=11&AreaTypeKeyGdp=0&GeoFipsGdp=XX&ClassKeyGdp=NAICS&ComponentKey=200&IndustryKey=101&YearGdp=2000,1999,1998,1997&YearGdpBegin=-1&YearGdpEnd=-1&UnitOfMeasureKeyGdp=PercentChange&Rank=0&Drill=1>

<sup>71</sup> “Federal Taxes Paid vs. Federal Spending Received by State, 1981-2005.” *The Tax Foundation*, 2007. Available online at <http://taxfoundation.org/article/federal-taxes-paid-vs-federal-spending-received-state-1981-2005>

<sup>72</sup> As the Mexican peso deteriorated in the late 1994 Peso Crisis, the United States rapidly intervened, both through open market peso purchases, and through up to US\$50 billion in loan guarantees.

<sup>73</sup> De Grauwe, 10.

<sup>74</sup> Though, in all fairness, the *Concertación* has largely followed a neoliberal economic model.

<sup>75</sup> Rachel Donadio. “Split Vote Sends One Clear Message: No to Austerity.” *The New York Times*, 2/25/2013. Available online at [http://www.nytimes.com/2013/02/26/world/europe/Italy-elections.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2013/02/26/world/europe/Italy-elections.html?pagewanted=all&_r=0)





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